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STATE PASS FEDERAL RESERVE BOARD FOR JOHNSON; SAN FRANCISCO
FRB FOR CURRAN/LUNG; NEW YORK FRB FOR DAGES/CLARK

E.O. 12958: N/A
TAGS: ECON EINV EFIN ETRD CH
SUBJECT: PBOC GOVERNOR AND SECRETARY PAULSON DISCUSS
CURRENCY FLEXIBILITY, FINANCIAL SERVICES

SUMMARY
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¶1. (SBU) SUMMARY: On July 31, People's Bank of China (PBOC) Governor Zhou Xiaochuan told United States Treasury Secretary Henry Paulson that he supports using dividend payments from state-owned enterprises (SOEs) to help rebalance China's growth and that only a relatively small share of payments will be used to finance new social expenditures. Zhou favors greater currency flexibility for the sake of more autonomous monetary policy but is concerned there is no common ground between the somewhat more aggressive appreciation favored by some in the Chinese Government and the massive appreciation that the United States Congress appears to be demanding. Zhou suggested that the United States might make more progress in SED financial services discussions by highlighting evidence of financial sector openness in other emerging markets and by expediting the approval of Chinese banks' branch applications. Finally, Zhou argued that the structural changes needed to address our trade imbalance will not occur overnight in either China or the United States, and the two sides should therefore consider additional options for managing political tensions. END SUMMARY

REDUCING IMBALANCES
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¶2. (SBU) Paulson asked about the prospects of having SOEs pay dividends that could be used to finance social services to reduce China's national savings rate (by reducing the need for household precautionary savings). Zhou responded that the PBOC had long supported having SOEs pay dividends to the government and that this would start in the second half of ¶2007. However, despite PBOC support it appears that only 10-20 percent of SOE dividends will go to the general treasury in MOF. The rest will go the State Asset Supervisory and Administration Commission (SASAC). (Comment: SASAC will reportedly use the funds to subsidize loss making SOEs or to establish new SOEs. End comment.)

¶3. (SBU) Paulson asked about the scope for fiscal stimulus to reduce public and household savings rates. Zhou said the while the PBOC believes there is some room for greater fiscal stimulus, the government needs to be cautious about increasing the government debt to GDP ratio. While explicit

government debt is not high (less than 30 percent of GDP compared to a sustainable rule of thumb level of 60 percent), implicit liabilities from unpaid pensions, non-performing loans, and rising public medical care costs are high. (Comment: Government assets, such as stakes in SOEs are also extensive, though the extent to which the government could or would be willing to sell these assets to finance liabilities is uncertain. End comment.)

MAINTAINING OPEN TRADE POLICIES
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¶4. (SBU) Paulson said he would lead the fight against trade protectionism and would not support legislation that targets China. Paulson stressed that for the Administration to do its part to keep markets open, it is important to show that engagement and dialogue are delivering results, particularly in food safety, currency, capital market liberalization, and investment. To achieve this, the SED should focus on advancing reforms that China believes are in its interest as well. One of Paulson's key concerns is that China will implement reforms but not until it is too late to constrain rising United States protectionism.

CURRENCY
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¶5. (SBU) On exchange rate policy, Paulson stressed that he would not support any policy changes that would hurt the Chinese economy, because this would not be good for the United States economy. While a few companies might have been hurt by the RMB's rise against the USD, Paulson sees no evidence that the RMB's appreciation is adversely affecting the broader Chinese economy. Rather, in Paulson's view, a



stronger and more flexible currency would enhance China's financial security by giving it more policy tools to avoid asset bubbles and maintain financial stability, as well as rebalance its economy towards more consumption-led growth. Paulson stressed that international pressure on China to change its exchange rate policy was likely to increase, including through the IMF. While noting that the RMB had appreciated by 9.5 percent in two years, Paulson did not understand why the appreciation had not been 15-16 percent.

¶6. (SBU) Zhou responded that the PBOC had long supported greater exchange rate flexibility, first and foremost because it gives the PBOC greater room to adjust monetary policy. While China's leadership could support appreciation at a slightly faster rate, they believe this will be insufficient to placate the United States Congress and what would placate Congress ) a 20-40 percent revaluation, is not politically viable in China. Thus, China's leadership believes there is little scope for finding common ground on this issue. Zhou said it would be helpful if Treasury could give the PBOC a better sense of how much appreciation is needed to placate Congress. While a new Chinese Government might revisit exchange rate policy next year, until then there is unlikely to be a major change in policy.

¶7. (SBU) Zhou added that, while United States policy makers believe that market prices will promote needed economic adjustments, and are advised by economists who rely on empirical data, China's older generation of political leaders still prefers administrative controls and fiscal changes (such as higher taxes or subsidies) targeted on sectors of concern over market-based policies such as interest and exchange rates that have a broader impact. This preference is based on their experience, even if not supported by data. As a result, Zhou expects Chinese leaders will wait to assess the impact of fiscal policy changes annouced in the last several months (which raised ffective taxation on certain export sectors that are resource intensive or highly polluting) before making any changes to exchange rate policy.

¶8. (SBU) Zhou said Paulson could more effectively promote his agenda if he addressed Chinese leaders' concerns that: 1) greater market access for foreign firms in financial services would adversely impact China's financial security, particularly the ability of Chinese firms to compete with foreign firms (Comment: Embassy interlocutors say this is a particular concern in the securities sector. End comment.); and 2) the United States protects its companies from competition through prudential supervision (such as bank licensing) and national security reviews (CFIUS) and thus China should as well. Zhou noted that if the Fed could accelerate its approval of Chinese banks' branch applications, this would remove an excuse for maintaining market access barriers in China,s financial sector and would not threaten the safety and soundness of the Unites States financial sector. Zhou also suggested that Paulson stress to China's leaders that most other emerging markets do not limit FDI in financial services, and note how open the United States is in the financial sectors, since China's leaders believe their own policies are the norm. Finally, he recommended not pressing China's leaders on currency policy unless the United States could reduce its demands to an amount that is viewed as more politically realistic in China.

¶9. (SBU) Zhou said it would be difficult to reduce trade imbalances in the near term since they are caused mainly by high savings in China and low savings in the United States, and it is difficult for policy changes to affect short-term savings rates. Given this, Zhou suggested it is likely that China will continue to accumulate large official assets and proposed that China and the United States consider how these investments could be made in a way that reduces bilateral trade tensions. In addition to investing in the United States, Zhou suggested that China could invest its official assets in NAFTA or CAFTA companies whose products have a high American content. Furthermore, Chinese companies do not understand the regulatory and political investment climate in the United State and other countries and could use advice from United States officials.



¶10. (SBU) Finally, Zhou commented that the United States SED proposal to reduce tariffs on environmental goods is worth pursuing. He also thanked the United States for its support of China's membership in the Inter-American Development Bank (IDB) and the Financial Action Task Force (FATF).

¶11. (U) Secretary Paulson's delegation cleared this cable.
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